Al Rajhi Bank
Ex. 15

Financial services report: Banks

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Body

There are 12 majority-Saudi-owned banks operating in the country. Several are partly owned by the state or by public-sector institutions such as the pension funds. Majority foreign ownership of banks-albeit capped at 60%-has been permitted since 2005. Since then, ten foreign banks have received an operating licence. Citigroup (US) is also said to be planning a return to the kingdom, having sold a 20% stake in a local bank in 2004.

Having stagnated in 2008-09, credit to the private sector is now recovering. Saudi banks have traditionally taken a cautious approach to lending, but in recent years abundant liquidity, government debt repayments and low interest rates contributed to a boom in cheap credit, with lending to the private sector expanding by an average of 27% a year in 2003-08. Inevitably, this level of lending growth raised concerns about worsening quality of loan portfolios.

More than other Gulf banks, Saudi banks tend to focus their lending within Saudi Arabia itself. While they appeared to remain protected from falling global and regional property markets, Saudi banks have been reported to have some exposure to the debt of Dubai World, the UAE conglomerate that requested a standstill on its debt, and to other troubled companies within the UAE. The government is unlikely to allow any of the Saudi-owned banks to fail, and has in the past intervened to save banks. The banks maintain a relatively strong level of provisioning for bad debts. According to results in 2010, most Saudi banks have remained profitable

The Saudi Arabian Monetary Agency (SAMA), the central bank, regulates the banking sector and takes a generally conservative approach. Nonetheless, a lack of transparency in the wider corporate sector is a concern. There is a shortage of information on borrowers' credit histories, with a consumer credit bureau only in its infancy. These factors, together with a lack of confidence in the ability of the judicial system to enforce default penalties, lead to a generally cautious approach to lending by banks and help to explain the conservative attitude of the regulator.

In addition, the government operates five specialised credit institutions that provide medium- and long-term concessional financing to the private sector and some public-sector enterprises. These are the Real Estate Development Fund; the Saudi Industrial Development Fund; the Saudi Agricultural Bank; the Saudi Credit Bank; and the Public Investment Fund. The role of these institutions will increase in order to supplement government spending and shore up economic growth in the early part of the forecast period.

Financial sector

	2005(a)	2006(a)	2007(a)	2008(a)	2009(b)	2010(c)
Total financial sector						
Total loans (US $ bn)	120.8	132.7	158.6	198.6	196.5	214.6

Deposits (US $ bn)	130.7	157.9	191.4	225.6	250.8	257.0
Current-account deposits (US $ bn)	58.5	65.0	82.9	91.2	115.5	142.1
Time & savings deposits (US $ bn)	72.1	92.9	108.4	134.4	135.3	114.9

(a) Actual. (b) Economist Intelligence Unit estimates. (c) Economist Intelligence Unit forecasts.

Source: Economist Intelligence Unit.

Financial sector

	2005(a)	2006(a)	2007(a)	2011(c)	2012(c)	2013(c)
Total financial sector						
Total loans (US $ bn)	120.8	132.7	158.6	252.0	295.0	343.4
Deposits (US $ bn)	130.7	157.9	191.4	276.2	301.4	331.4
Current-account deposits (US $ bn)	58.5	65.0	82.9	156.3	179.7	208.5
Time & savings deposits (US $ bn)	72.1	92.9	108.4	119.9	121.7	122.9

(a) Actual. (b) Economist Intelligence Unit estimates. (c) Economist Intelligence Unit forecasts.

Source: Economist Intelligence Unit.

Financial sector

	2005(a)	2006(a)	2007(a)	2014(c)
Total financial sector				
Total loans (US $ bn)	120.8	132.7	158.6	396.3
Deposits (US $ bn)	130.7	157.9	191.4	364.0
Current-account deposits (US $ bn)	58.5	65.0	82.9	243.9
Time & savings deposits (US $ bn)	72.1	92.9	108.4	120.1

(a) Actual. (b) Economist Intelligence Unit estimates. (c) Economist Intelligence Unit forecasts.

Source: Economist Intelligence Unit.

Retail banking demand. Demand for retail banking has been increasing steadily in recent years as consumers have changed their habits from dealing predominantly in cash to depositing savings in banks. This trend has been underpinned by rising liquidity associated with strong oil export earnings (which are injected into the domestic economy through hefty annual increases in government spending) and the development of electronic banking services and payment systems. Salaries are increasingly being paid directly into bank accounts. Demand for Islamic retail banking services has been growing particularly strongly.

Consumer lending has largely stagnated since 2005, primarily owing to a cap that was introduced by the central bank in 2006, aimed at lowering the amount of consumer debt that was devoted to investing in the stockmarket. Consumer loans are limited to tenors of five years and total monthly loan repayments (including credit-card repayments) must not exceed 30% of the borrower's monthly salary-although this does not currently include mortgage repayments.

Consumer lending accounted for 26% of all credit to the private sector in June 2010 and has grown by 8.5% so far this year. Growth in consumer lending is therefore likely to expand strongly in coming years as economic growth recovers. A growing population and a high rate of household formation are also likely to drive demand for debt.

The risk of default on consumer loans is limited by the widespread practice of salary assignment whereby the bank makes its loan conditional on the borrower's salary being paid into a current account at that bank, from which it can deduct its repayment immediately.

Credit-card borrowing has increased strongly in recent years, although it has fallen in 2010. It currently accounts for 4.2% of total consumer borrowing. As with broader consumer lending, credit-card lending growth will depend on salary growth because of the lending cap. The further development of the credit-card industry will also depend on

addressing the currently widespread fears about fraud, and ensuring that the national electronic payments system is more reliable. Transactions are sometimes declined because of technical failures, which can be embarrassing for users. The central bank is working to improve the electronic payments system. Credit-card interest rates tend to be high.

A mortgage law has been approved by the Majlis al-Shura (an appointed council that advises the government) but is now awaiting review. The council postponed the review in July 2010 without giving a reason for doing so. However, even when the new law is enacted it will take considerable time to develop a viable and active mortgage market owing to caution on the part of banks and regulators and the difficulties of ensuring that the market remains compliant with Islamic laws, particularly relating to repossession. Banks will be particularly concerned about their ability to enforce penalties against defaulters, given the slow and unpredictable nature of the judicial system-judgements are based on interpretation of sharia (Islamic law) rather than a system of precedent. Land rights and laws may also need considerable development before they can provide a firm basis for the mortgage market. As the mortgage industry develops, it will encourage the growth of asset-backed debt markets, which are currently underdeveloped in Saudi Arabia.

National Commercial Bank (NCB), the country's largest bank by total assets, said in a report issued in February that the new law might double the size of the property market by 2015 and that it expected residential prices to rise by 20% annually over the next three years. Although some home lending does already exist in Saudi Arabia, financial institutions have hitherto been reluctant to enter the market because of the lack of a central regulator and any clearly defined mortgage legislation. The new law, once in place, is widely expected to attract strong interest from public- and private-sector lenders. Several mortgage finance providers have already been established in the kingdom in anticipation of the new law, with the Public Investment Fund (PIF), a state investment agency, set to take 40% stakes in new lenders to provide oversight and support. Deutsche Bank has formed a joint venture, which will offer mortgages compliant with the sharia rules, with partners in Saudi Arabia. The German lender holds 40% in the new company.

The "Islamic finance" share of the retail banking market has risen strongly in recent years. (Islamic financial products are designed to comply with sharia law and are therefore forbidden to invest in activities deemed to be haram, such as gambling or alcohol businesses, or to charge interest, although some other forms of returns are permitted.) A number of existing banks have phased out conventional retail banking services in favour of sharia-compliant versions. The maturity of this market is hard to assess as the central bank does not recognise Islamic banks as a separate category and data on the size of the sharia-compliant subsector is lacking. Sharia-compliant mortgages may dominate the home-lending market.

All Saudi banks provide women-only branches, with female staff. The female customer base has expanded as banks have launched marketing campaigns to promote their "ladies' banking" services. There is also increasing interest on the part of Western financial institutions in catering for wealthy Saudi women. Women own an estimated 30% of the money in the Saudi banking system, in part as a result of inheritance under sharia, although only a small proportion of Saudi women work.

Commercial banking demand. Lending to private businesses has risen strongly in recent years. Although it stagnated in 2008-09 it has begun to expand again. The single largest sector for corporate lending is "commerce", including retailers, which accounted for 24% of private credit in June 2010. This was followed by the manufacturing sector (10%) and building and construction (6.9%). Large increases in lending were recorded in commerce and building and construction, while lending to the services sector fell dramatically. The figures suggest that banks have reverted to increasing lending levels, having retrenched in late 2009 after allegations of fraud between two of the largest Saudi conglomerates caused concern.

The investment banking sector has also begun to develop. A number of foreign investment banks have obtained licences to operate in the country. Investment banks do not require a local partner, but in practice banks with a local partner tend to have advantages in terms of local knowledge, information on potential employment candidates, personal connections and so on.

A rising number of government-backed infrastructure and industrial projects have required extensive project finance, which only reached US$1.9bn in 2009, but is set to make a remarkable recovery in 2010. The state-owned mining company, Maaden, launched a US$7.5bn project-financing package in April for a US$10.8bn aluminium smelter and rolling mill that it is constructing with a joint-venture partner, Alcoa (US). Saudi Aramco, the state-owned oil firm, has received commitments from banks for a 400,000-b/d refinery it is developing with Total of France at Jubail-the total debt will be US$8bn including a sukuk (Islamic security) to be issued in the future-and will be looking for a further US$7.7bn of financing for another refinery at Yanbu. The Capital Market Authority (CMA) also announced in April that it had approved a Saudi Electricity Company (SEC) request to issue a sukuk, but no value has been specified. SEC is in the process of raising finance for two power stations with total costs in the region of US$5bn (although a large proportion of this may be met from a SR15bn (US$4bn) loan it received from the government in April). Marafiq, a predominantly state-owned water and power utility, announced at the end of April that it was seeking to borrow US$800m as a 15-year corporate loan to fund new power projects. It is likely that financial markets are capable of meeting the increasing number of financing requests. Local banks are highly liquid and will be assisted by well-funded Saudi development funds and a number of export credit agencies.

The rising levels of activity in commercial lending, including substantial interest from international lenders and investors, show that the sector has largely recovered from the financial crisis and local and regional debt problems. Corporate credit demand will continue to be driven by the large number of upcoming industrial and infrastructural projects. Many of these are well supported by the government owing to their strategic importance, such as railways and roads, mining and petrochemicals projects, and power and water projects. Private partners or contractors will still need to raise some of the capital.

Small and medium-sized enterprises (SMEs) find it relatively difficult to access bank finance, given banks' traditional preference for large, well-known corporates. Access to credit is particularly difficult for businesswomen, a situation that is likely to change only slowly. SMEs and enterprises headed by women tend to lack collateral and credit histories. Over the forecast period, banks are likely to place an increasing emphasis on proof of direct access to collateral as a requirement for borrowing.

The practice of "name lending"-lending to well-known family businesses on the strength of their name and reputation-is likely to be wound down following the defaults of two well-known Saudi conglomerates, Ahmed Hamad Algosaibi & Bros and the Saad Group, in 2009. It is estimated that around 80 banks, including BNP Paribas (France) and Citigroup, are owed around US$16bn. Various legal actions have been launched around the world, although many of them have determined that the case should be tried in Saudi Arabia, which will be a critical test for the legal system.

Another increasingly important source of funding is the government investment funds. The state-owned Saudi Industrial Development Fund (SIDF), which issues loans for industrial projects in the kingdom, was granted an additional SR10bn (US$2.7bn) in May 2010. In its latest annual report the SIDF announced that it had approved 111 development loans in 2009, worth a total of SR5.2bn. This was substantially lower than the SR8.8bn of loans that it approved in 2008, which the fund attributed to uncertainty resulting from the regional and global economic situation. However, the SIDF said that the amount actually paid out in 2009 reached SR5.4bn-some 7.6% higher than in 2008 and a record for any single year, suggesting that funding accelerated in 2009 as part of the government's wider stimulus package and record spending projections announced in its annual budget.

Banking sector

	2005(a)	2006(a)	2007(a)	2008(a)	2009(b)	2010(c)
Bank performance						
Banking assets (% change in local currency)	15.8	13.4	24.9	21.1	5.2	3.0
Bank loans (% change in local currency)	36.2	9.8	19.7	25.2	-1.1	9.2
Bank deposits (% change in local currency)	12.3	20.8	21.4	17.9	11.2	2.5
Net interest income (% change in local currency)	18.3	14.7(b)	14.2(b)	14.6(b)	7.3	4.2
Net margin (net interest income/assets; %)	3.2	3.2	2.9(b)	2.8(b)	2.8	2.9

(a) Actual. (b) Economist Intelligence Unit estimates. (c) Economist

Intelligence Unit forecasts.

Source: Economist Intelligence Unit.

Banking sector

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Bank performance						
Banking assets (% change in local currency)	15.8	13.4	24.9	8.0	10.0	11.0
Bank loans (% change in local currency)	36.2	9.8	19.7	17.4	17.1	16.4
Bank deposits (% change in local currency)	12.3	20.8	21.4	7.5	9.1	10.0
Net interest income (% change in local currency)	18.3	14.7(b)	14.2(b)	9.3	9.4	9.0
Net margin (net interest income/assets; %)	3.2	3.2	2.9(b)	2.9	2.9	2.8

(a) Actual. (b) Economist Intelligence Unit estimates. (c) Economist Intelligence Unit forecasts.

Source: Economist Intelligence Unit.

Banking sector

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Bank deposits (% change in local currency)	12.3	20.8	21.4	9.8
Net interest income (% change in local currency)	18.3	14.7(b)	14.2(b)	9.5
Net margin (net interest income/assets; %)	3.2	3.2	2.9(b)	2.8

(a) Actual. (b) Economist Intelligence Unit estimates. (c) Economist Intelligence Unit forecasts.

Source: Economist Intelligence Unit.

Supply. A total of 22 banks have a licence to operate in Saudi Arabia, although in practice the sector is dominated by 11 Saudi banks, which account for most of the branch network. The sector has been liberalised since 2005, when the country joined the World Trade Organisation (WTO). Since then, banks from any country have been allowed to open local branches, subject to obtaining a licence. Foreign firms have been allowed to increase their equity share in existing joint ventures to 60%, from 40% previously. Banks from other GCC states have been allowed to operate in the kingdom since 1999.

In October 2005, BNP Paribas, became the first European bank to open an office in Saudi Arabia as a wholly foreign-owned bank. In the same year, the CMA extended licences to another nine foreign banks including JP Morgan (US), Bank Muscat (Oman), the National Bank of Kuwait, the National Bank of Bahrain, Emirates Bank and National Bank of Pakistan. In 2004, just before this wave of liberalisation, there were only 11 banks, including the country's second sharia-compliant financial institution, Bank al-Bilad, which was established that year. Previously, there had been only ten banks for the best part of two decades. Another sharia-compliant bank, Al Inmaa, was licensed in 2006 and began operations in late 2008. Overall, the number of bank branches in the country rose from 1,216 in 2003 to 1,450 in June 2009. The number of ATMs more than doubled, from 3,676 in 2003 to 10,462 over the same period.

In recent history, high liquidity from strong oil revenue has contributed to a rise in deposits, prompting very strong growth in lending to the private sector. Meanwhile, the government has used portions of the fiscal surpluses recorded between 2003 and 2008 to repay its domestic debt, further boosting bank liquidity. Banking profits have been boosted by high margin spreads and by the amount of money deposited in non-interest-bearing accounts at Saudi banks. Over the same period, banks' main complaint has been rising costs, particularly for staff. Liquidity conditions began to tighten in 2008, but a series of interest rate cuts by the central bank, coupled with reductions in reserve requirements, helped to bring interbank rates down in 2009. The central bank also injected some US$3bn of deposits into the banking system, and the government has reiterated the fact that it guarantees bank deposits.

Financial services report: Banks

Second-quarter bank results in 2010 were mixed as provisions for bad loans continued to weigh heavily on balance sheets. However, all Saudi banks are now profitable again after some banks made losses during 2008-09. Although there is a risk that some further provisions for bad loans may need to be taken in 2010, the outlook for bank performance is healthy. An expansionary government budget and higher average oil prices in 2010 than in 2009 are likely to help boost business activity and bank lending.

Interim Saudi bank results

(SR m)

	2 Qtr 2010	4 Qtr 2009
National Commercial Bank		
Net profit	1,243	770
Total assets	263,272	257,452
Samba Financial Group		
Net profit	1,220	835
Total assets	188,357	185,518
Al Rajhi Bank		
Net profit	1,779	1,470
Total assets	177,287	170,730
Riyad Bank		
Net profit	766	912
Total assets	169,337	176,399
Saudi Fransi Bank		
Net profit	757	324
Total assets	120,562	120,572
Saudi British Bank		
Net profit	447	26
Total assets	120,309	126,838
Arab National Bank		
Net profit	629	296
Total assets	106,209	110,297
Saudi Hollandi Bank		
Net profit	250	-439
Total assets	59,461	59,110
Saudi Investment Bank		
Net profit	22	-110
Total assets	48,866	50,148
Bank Al Jazira		
Net profit	21	-266
Total assets	29,169	29,977
Al Inma Bank		
Net profit	3	6
Total assets	24,948	17,306
Bank al-Bilad		
Net profit	33	-299
Total assets	18,916	17,411

Source: company announcements to Tadawul and NCB (unaudited).

The NCB is the country's largest bank by assets, and has been majority owned by the government (through the PIF) since 1999. It was the country's first bank. The possibility of floating 50% of the NCB's shares through an initial public offering has been discussed since 2004. NCB has an investment banking offshoot, NCB Capital, although this is based in Bahrain (where it tends to be easier to obtain visas for expatriate staff or business visitors). Between 1991 and 2006 the NCB converted all of its retail branches into sharia-compliant banks.

Samba, another leading player in the banking sector, was formed in 1980 to take over the branches then operated by the US-based Citibank, following a government ruling that all foreign banks had to sell a majority share to Saudi nationals. Citibank maintained a share in Samba until 2004, but since then the company has been wholly Saudi-owned and managed.

Other key players with an established presence in the kingdom include the wholly Saudi-owned Riyad Bank, Banque Saudi Fransi (affiliated with Calyon of France), Saudi Hollandi Bank (in which the UK-based RBS has a 40% stake) and SABB (an affiliate of HSBC, another UK-based bank).

Only a minority of the Saudi banks are fully fledged Islamic institutions. However, most offer a mix of Islamic and conventional services, and most are increasingly focusing on sharia-compliant services, as demand grows rapidly. The first 100% sharia-compliant bank was Al Rajhi Bank, established in 1957. Bank al-Bilad followed in 2004. A third, Al Inma Bank, began operations in 2009. There are also two Islamic finance houses operating in Saudi Arabia: one, Dallah al-Baraka, is wholly based in the kingdom and operates out of Jeddah; the other, Dar al-Maal al-Islami, is based in Geneva, Switzerland, but has branches in Saudi Arabia and Bahrain.

The regulatory authorities are unlikely to award more new licences to retail banks until the impact of the recent liberalisation becomes clearer. Some of the smaller and less-efficient banks will probably see revenue decline as a result of the increased competition, potentially leading to some consolidation of the market through mergers. However, the government will seek to attract more commercial banks and non-bank lenders to Saudi Arabia, as part of its efforts to develop the capital, Riyadh, as a financial centre.

Construction of a new financial district in Riyadh, the King Abdullah Financial District, began in 2007. It will face some competition from existing financial centres in the region. However, banks need a local presence in order to do significant business in the kingdom-which is by far the largest GCC market.

Traditionally, the banks have provided asset management and brokerage services as well as commercial and retail services. Since 2006, they have been required to spin off asset management and brokerage operations into separately licensed institutions. The CMA has also licensed a wider range of specialised financial institutions not connected with established banks.

The banking sector is well capitalised, reflecting the strong growth of liquidity in recent years and a generally cautious attitude to lending that helps to insulate it from risk (although lending practices may have become less cautious in recent years as credit growth has boomed on the back of abundant, cheap liquidity). All Saudi banks were required to implement Basel II's standardised approach for credit risk and the standardised or basic indicator approach for operational risk from January 2008. Major banks are required to plan for a transition to more advanced approaches to credit risk by 2011. The ratio of capital and reserves to total assets was 13.2% in June 2010, up from a low of 11.8% in November 2009 and 8.8% in 2005, reflecting greater risk aversion by banks.

The aggregate loan/deposit ratio was 102% in June 2010. However, when lending to the government is stripped out, the private-sector loan/deposit ratio was 81%-the risk of sovereign default is perceived to be very low. The vast majority of Saudi bank lending is to the local market. However, foreign assets accounted for 11.8% of all bank assets in 2008 and 15.4% in June 2010.

Lending to the central government has declined in recent years as the government recorded large fiscal surpluses and paid down its debt. The government has accumulated substantial savings (roughly equivalent to one year's nominal GDP) which it can draw on to finance future deficits. The future public-sector borrowing requirement is

likely to be volatile, and is subject to risks from the international oil market as the public finances are heavily dependent on oil earnings. The growth of the insurance and mortgage markets may require the government to issue more debt in order to provide the banks and insurance firms with long-term liquidity management tools.

Average returns on assets will continue to benefit from the maintenance of high spreads between deposit and lending rates, reflecting a lack of price competition in the sector. Moreover, the Islamic banks, and some of the conventional banks, do not pay interest on their current accounts (in line with the prohibition under sharia against riba, which is variously interpreted as interest or usury). However, the proportion of deposits held in time and savings accounts has begun to rise as consumers seek greater returns on their savings, which may reduce conventional banks' margins.

Several international investment banks have launched joint ventures in the kingdom in recent years, attracted by the booming market for project finance as well as the easing of official restrictions on foreign investment. HSBC (UK) was the first of these, having set up a local investment banking firm, HSBC Saudi Arabia, in 2006. This is a joint venture with SABB, which was already an HSBC affiliate. Morgan Stanley (US) also signed an agreement in January 2007 to set up a local investment bank, Morgan Stanley Saudi Arabia, as a joint venture with The Capital Group, a boutique investment house based in Riyadh. Merrill Lynch (US)-now part of Bank of America-launched its own fully owned office in Saudi Arabia after gaining a licence in 2007.

Bank regulators. SAMA, which is based in Riyadh, is under the supervision of the Ministry of Finance. SAMA issues currency and regulates commercial banks and other financial institutions under its control. It manages the government bond programme, oversees the foreign-exchange market and stockmarket, and manages the nation's electronic debit payment system. SAMA also closely monitors international loan syndications and has a say in any government or private-sector moves to develop financial institutions, systems and instruments. The CMA is responsible for licensing and regulating investment banking activities. SAMA takes a highly conservative approach both to domestic bank regulation and to the investment of the kingdom's surplus oil earnings. SAMA manages a large part of the country's foreign assets and has adopted a low-risk strategy, maintaining the bulk of its external balances in US dollar-denominated fixed-income securities.

Staffed largely by Western-educated technocrats, SAMA is well regarded as an efficient and effective regulator, and has been the driving force behind most efforts in recent years to strengthen and reform the banking and financial services sector. SAMA has intervened to support banks in difficulty, and it is widely believed that no bank failures will be allowed. SAMA has also set caps on consumer lending. It also uses reserve requirements as a monetary policy tool, particularly as it has limited flexibility to vary interest rates; the Saudi riyal's peg to the US dollar, combined with an open capital account, means that local policy rates have roughly to follow trends in US interest rates.

Saudi Arabian Monetary Authority: www.sama.gov.sa

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